Internal Revenue Service

memorandum

CC:TL:Br3
PSHorn

date: AUG 24 1987

to: District Counsel Manhattan CC:MAN

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]
Dkt. No. [redacted]
[redacted]
Dkt. No. [redacted]
Your ref: CC:MAN:TL: SKatz-Pearlman

This is in response to your technical advice request dated August 7, 1987, in which you inquired whether your office should litigate the above-captioned cases.

ISSUE

Whether the petitioner, a member of a professional [redacted], may escape taxation on the compensation received for performing services for the team by contracting to have the compensation paid by the team to his personal service corporation ("PSC").

CONCLUSION

The petitioner is a common law employee of the team and therefore interposing his PSC as the receipient of the compensation does not allow petitioner to avoid taxation on these amounts.

DISCUSSION

[redacted] ("[redacted]") was a [redacted] for the [redacted] ("[redacted]") during the period at issue, years prior to the effective date of section 269A. [redacted] formed a PSC ("[redacted]") of which he was the sole shareholder. [redacted] entered into an employment contract with [redacted] which provided that [redacted] would perform services for [redacted] in exchange for a salary. [redacted] then entered into an employment contract with the [redacted] which purported to provide [redacted]'s services to the [redacted] in return for the [redacted]s payment for such services to [redacted].

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[redacted] did not include in income amounts paid by the [redacted] to [redacted] only that which was eventually paid to him by [redacted] as salary. In addition to paying [redacted] a salary, [redacted] established a qualified pension plan, which, when added together with the salary paid to [redacted], eliminated almost all of [redacted]'s taxable income.

The issue in this case has previously been the subject of extensive technical advice from this office. In our most recent technical advice response of October 4, 1985, we stated that this issue had been reexamined and that it was now our position that an incorporated individual of this type is a common law employee of the entity to which he renders his services, i.e. the team rather than of the PSC.

You raise several items as litigating hazards which you perceive as justifying concession of this case. The points you raise are as follows: (1) recent Tax Court opinions indicate little likelihood of success in this area, (2) respondent has conceded an identical case with the same attorney who represents petitioner herein, and (3) this case would be of little precedential value because of the effect of section 269A for years beginning after December 31, 1982.

As to the first point raised, we do not agree that recent Tax Court opinions indicate little likelihood of success on this issue. As an example of our litigating hazards in this area you cite to Haag v. Commissioner, 88 T.C. No. 32 (March 16, 1987), wherein Judge Williams, who will also hear this case, held that respondents' attempts under sections 61 and 482 to reallocate income from the physican's personal service corporation to the individual were improper.

We believe that Haag and those cases of similar ilk which preceded it are distinguishable, however, from this case. While we acknowledge that litigating hazards naturally remain associated with this area, this is still an issue worth pursuing. Furthermore, even in Haag the court did allow for reallocation of income to the extent there was a difference between the amount of compensation which would have been received in each year absent incorporation and the amount actually received.

This case is distinguishable from that which has gone before for several reasons, the most important distinction being the applicability of the common law employee argument to attribute the salaried amounts directly to the [redacted]. In Achiro v. Commissioner, 77 T.C. 881 (1981), footnote 27, and Johnson v. Commissioner 78 T.C. 882 (1982), footnote 21, the Tax Court suggested that in cases involving PSCs, an alternative argument to the sections 61 and 482 approach would be that the individuals were common law employees of another entity.

In Professional & Executive Leasing, Inc. v. Commissioner, 89 T.C. No. 19 (August 3, 1987), we successfully used the common law employee approach to show that various professionals could not merely by contract establish an employment relationship with petitioner, a leasing organization. In that case the petitioner created an arrangement by which numerous individuals entered into contracts of employment with the petitioner and then were "leased" by the petitioner back to the employers for which the individuals previously worked. Almost all the individuals had an equity or ownership interest in the entity to which they were "leased". The impetus behind this scheme to make the individual an employee of the petitioner was to provide a lucrative retirement plan to each individual without the attendant cost of providing nondiscriminatory coverage to the support staffs of the various entities that these individuals owned or controlled.

We did not challenge petitioner's existence as a viable corporation nor pursue an assignment of income theory. Instead we simply argued that nonwithstanding the contracts entered into by the parties, the individuals remained employees of the entities to which they were "leased". Therefore the retirement plans established by the petitioner for the individuals were not qualified since they covered nonemployees. The court looked at our employment tax regulations and the Restatement of Agency 2d, Section 220 (1958). It stated that a contract purporting to create an employer-employee relationship did not control where the common law factors (as applied to the facts and circumstances) establish that the relationship does not exist.

In reaching its conclusion the court cited Bartels v. Birmingham, 332 U.S. 126 (1947), wherein the Supreme Court determined that certain orchestra members were employees of the orchestra leader and not of the operators of various dance halls where they performed. After applying the common law rules to the facts of the case, the Court held that the orchestra leader was the employer (and therefore responsible for the employment tax) despite the formal contractual agreement designating the proprietors of the dance halls as the employers.

Similarly, in Edward L. Burnetta, O.D., P.A. v. Commissioner, 68 T.C. 387 (1977), the Tax Court held that certain individuals who worked in the offices of two professional corporations were the common law employees of those corporations rather than of a separate payroll service corporation that maintained the workers' records and issued their paychecks.

We believe that there is ample authority to argue that a [redacted], or any other athlete, is the common law employee of the team and not his PSC. Furthermore, in the context of a professional athlete playing a team sport, our position is even more favorable than that posed by the doctor or business

professional. As restated in Professional & Executive Leasing, Inc., supra, the test usually considered fundamental in examining the employment relationship is "whether the person for whom the work is performed has the right to control the activities of the individuals whose status is in issue, not only as to results but also as to the means and method to be used for accomplishing the result".

The control, salary, etc., evidence in this case establishes that the employment relationship runs to the [redacted] and not to the PSC. It is clear that the [redacted] is required to comply with instructions from the [redacted] and coach about where, when, and how he is to perform the services for which compensation is to be paid. This situation is different from that posed by a truly self-employed individual who forms a PSC and does not have to answer to similar authority. In addition to the above, several other factors indicative of the athlete's employment relationship with the [redacted] are worth noting: (1) the [redacted] is periodically paid an annual salary rather than a lump sum; (2) the [redacted] pays the player's business and travel expenses, and (3) the [redacted] furnishes uniforms, equipment, etc.to be used in performing the services. We therefore conclude that the [redacted] is an employee of the [redacted] and that amounts paid for his performance of services are attributable to him and cannot be assigned to his PSC.

In addition to your general inquiry as to the litigation hazards regarding this matter, you also point out that the IRS has previously conceded other cases of this type and that at least one of these cases was with the same attorney representing petitioner herein. While the petitioner's representative may expect that all his clients should receive similar treatment, we do not think that proceeding in this matter will place the IRS in an awkward position. The IRS, like any large government agency, has a multitude of complex issues to pursue and develop. In this instance the agency reevaluated its litigation position in response to court decisions and the applicability of new legal theories and has determined that it should proceed with the remaining cases in this area. We also note that in our memorandum of October 4, 1985, we did recommend that your office defend the Smith case but we were subsequently informed that the case was already in the processs of being conceded.

As to your final point, you state that the precedential value of this case would be extremely limited given the enactment of section 269A for tax years beginning after December 31, 1982. Even if section 269A were a cure-all, there still are numerous pending cases on this issue with substantial deficiencies worth pursuing. Furthermore, we do not believe that this case is of limited precedential value because the precise breath and impact

of section 269A is not clear. For instance, assume post-section 269A that a [redacted] has a PSC and also earns substantial additional income through the PSC via endorsements, advertising, etc. It is not clear that those amounts received by the PSC from the [redacted] as salary could necessarily be included in the player's income as a result of section 269A.

That section in part allows an allocation of income and other allowances

> "if substantially all of the services ... are performed for ... 1 other corporation, partnership, or other entity..." (emphasis supplied).

In the assumed factual situation the taxpayer could argue that the PSC was providing services to or on behalf of more than one entity. A similar situation may arise with respect to a secretary who in addition to her normal salary from a college may earn substantial income typing term papers or other similar items for various persons or entities. Again section 269A may not reach this situation, but clearly the secretary should not be allowed to incorporate to avoid direct inclusion of the college salary in income.

In conclusion we recommend that this case be litigated and would be glad to assist you as necessary in the handling of this mattter. If you have any further questions, Paul Horn (566-3442) is handling this case in our Division.

Sincerely,

WILLIAM F. NELSON
Chief Counsel

By: [signature]
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Attachments:

[redacted]
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